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In the Supreme Court of the United States

OCTOBER TERM, 1980

JOHN NUVEEN & CO., INC., ET AL.,
PETITIONERS

v.

HENRY T. SANDERS, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTIONS PRESENTED

1. Whether petitioner Nuveen, a securities underwriter, sustained its burden of proof under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), that "in the exercise of reasonable care [it] could not have known" of material misstatements and omissions in communications it made in connection with its sale of securities.

2. Whether petitioner Nuveen, which sold securities "by means of" misleading prospectuses, was properly held liable under Section 12(2) of the Securities Act to members of the plaintiff class who did not prove that they received copies of the prospectuses.

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

STATEMENT

1. Beginning in September 1968, petitioner John Nuveen & Co., Inc. ("Nuveen"),[1] a broker-dealer, began to underwrite securities in the form of short-term notes issued by Winter & Hirsch, Inc. ("WH"), a consumer finance company (Pet. App. 28, para. 27). From that date until February 1970, Nuveen underwrote and sold virtually all of the short-term notes issued by WH (*ibid.*). In February 1970, WH collapsed after the discovery that certain of its principals, together with its accounting firm, had engaged in a massive fraud and had concealed the fact that the company was insolvent (Pet. App. 3-5; 24-25, paras. 13-14; 66).

Respondents are a class of 42 individuals and firms that, between June 30, 1969, and February 10, 1970, purchased WH notes with a face value of $1,612,500 from Nuveen (Pet. App. 3; 25, para. 16). The WH notes, rated as less than "prime" quality (Pet. App. 30, para. 37), were sold to the public by some of Nuveen's 172 registered representatives (Pet. App. 27, para. 26; 29, paras. 32, 33). Nuveen, unaware of the fraud, sold the notes on the basis "that there should be no question but what the paper will be paid at maturity" (Pet. App. 4; 30, para. 35). Over half of the WH notes were sold to, or for the account of, individuals (Pet. App. 29, para. 30). They were sold in denominations as low as $1,000 (III App. 419, 443).[2] Prior to their purchases of WH notes, some of the investors received from Nuveen materially misleading reports about the WH notes and at least some of them received from Nuveen materially misleading oral

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[1]The other petitioners in this case are two corporations held liable for Nuveen's actions due to their status as controlling persons.

[2]"App." refers to the four-volume appendix in the court of appeals.

communications about WH (Pet. App. 4; 6 & n.3; 38-40, paras. 70-76). After their purchases, all of the investors received confirmation statements from Nuveen stating that Nuveen had sold them the WH notes (Pet. App. 4). At the time of the sales, Nuveen had not learned and accordingly did not disclose in its reports, oral communications or confirmation statements the material fact that WH was in financial distress (Pet. App. 5).

In November 1969, rumors began to circulate among WH's lenders that WH's financial statements "were not right" (Pet. App. 23, para. 11). As a result, in January 1970 the lenders forced WH to retain a new accounting firm to conduct a full audit (Pet. App. 23-24, para. 11). Shortly after the audit was commenced the fraud was discovered. Upon learning of the fraud in February 1970, Nuveen stopped selling WH notes (Pet. App. 36, para. 60). The notes held by the respondent investors were dishonored by WH (Pet. App. 5). Through a liquidation distribution, respondents received approximately two-thirds of the amounts they paid Nuveen for the notes (*ibid.*).

2. In March 1970, respondents filed a class action complaint against Nuveen in the United States District Court for the Northern District of Illinois, alleging violations of various provisions of the federal securities laws in connection with Nuveen's underwriting and sale of WH notes. Respondents sought to recover the unpaid balance of the purchase price of the notes. Following a trial in the district court and three appellate decisions,[3] the district court held

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[3]In *Sanders I*, 463 F. 2d 1075, cert. denied, 409 U.S. 1009 (1972), the court of appeals held that the WH notes were securities. In *Sanders II*, 524 F. 2d 1064 (1975), vacated and remanded, 425 U.S. 929 (1976), the court affirmed a judgment in respondents' favor based on Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b). In *Sanders III*, 554 F. 2d 790 (1977), on remand for reconsideration in light of *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the court reversed the Section 10(b) judgment because scienter had not been proven. The court of

that Nuveen was liable under Section 12(2) of the Securities Act, 15 U.S.C. 77*l*(2), because it had sold securities by means of false and misleading prospectuses[4] and oral communications (Pet. App. 40, para. C-2; 42-43, paras. C-14 to C-16) and had failed to make an investigation sufficient to give it "reasonable grounds for believing that the financial condition of WH was such that WH would have the ability to pay its notes as they matured" (Pet. App. 41, para. C-5; see also *id.* at para. C-7).

In evaluating the issue of reasonable care, the district court was required to assess conflicting evidence. Nuveen asserted that it relied on certified financial statements showing a substantial profit, which supposedly had been audited by WH's accountants. Nuveen had "mistaken[ly] but honest[ly]" believed that those statements truthfully represented WH's financial condition (Pet. App. 5; 36, para. 63; 65). In addition, Nuveen had ascertained that various banks had extended credit to WH (Pet. App. 31, para. 41; 35, para. 60; 65). Furthermore, one of Nuveen's credit analysts spent a day at the offices of WH and examined certain records relating to its business transactions (Pet. App. 32, para. 46; 65).

In maintaining that Nuveen's actions had not been reasonable, respondents argued that Nuveen's personnel did not know and never attempted to meet anyone at the accounting firm that purportedly audited WH's financial statements. Furthermore, Nuveen never made any inquiries

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appeals remanded the case to the district court for further proceedings to consider respondents' claims under the Securities Act of 1933, 15 U.S.C. 77a *et seq.* The Securities and Exchange Commission participated in the court of appeals as amicus curiae in *Sanders III.*

[4]The term "prospectus" is defined in Section 2(10) of the Securities Act of 1933, 15 U.S.C. 77b(10), to include any written communication "which offers any security for sale or confirms the sale of any security."

of the auditor (Pet. App. 32, para. 44). Although the auditor's opinions noted that the certified financial statements had been prepared "without detailed audit" (Pet. App. 6; 37, para. 66), Nuveen prepared and distributed reports, incorporating portions of the certified financial statements, which erroneously stated that the financial data were in fact based on a detailed audit (Pet. App. 6). In addition, although Nuveen's credit analyst testified that he probably did examine WH's tax returns (Pet. App. 33, para. 47), WH's tax returns showed a loss of approximately one million dollars, while its financial statements reflected substantial profits (II App. 117, 152). Finally, the evidence showed that Nuveen did not examine WH's corporate minutes or its records of corporate actions (Pet. App. 31, para. 39).

In addition to holding that Nuveen was liable under Section 12(2) because it failed to exercise reasonable care necessary to avoid misleading investors, the district court also found that Nuveen was liable under Section 12(1) of the Act, 15 U.S.C. 77*l*(1), because it had sold WH's notes when no registration statement was in effect (Pet. App. 43, paras. C-18 & C-19).

3. The court of appeals affirmed the district court's decision, concluding that Nuveen was liable under Section 12(2) of the Securities Act (Pet. App. 2-14). The court found it unnecessary to decide whether Nuveen also was liable under Section 12(1) (Pet. App. 3 n.1). In finding liability under Section 12(2), the court of appeals focused on the misleading reports distributed by Nuveen to some members of the plaintiff class prior to their purchases. Since misleading reports had in fact been distributed to members of the plaintiff class, the court reserved decision on the question whether Nuveen also was liable on grounds that it had made misleading oral statements in connection with the sales, had failed to disclose material facts when it forwarded confirmation statements, or had implicitly represented that the

securities were issued by a solvent company when it underwrote and distributed them to the public (Pet. App. 6 n.3).

The court of appeals affirmed the district court's factual finding that Nuveen failed to exercise reasonable care to avoid misleading investors, noting that "what constitutes reasonable care under Section 12(2) depends upon the circumstances" (Pet. App. 13). After summarizing the evidence, the court pointed out that Nuveen was the "exclusive underwriter" of the WH notes (Pet. App. 4; see also *id.* at 69-72), that a "greater quantity of information" was available to Nuveen as an underwriter than would be available to a mere broker (*id.* at 10), and that the WH notes were sold to public investors without registration (*id.* at 13 n.13). The court also incorporated by reference (*id.* at 13) the analysis contained in one of its prior decisions in this case, which had noted that the "short term" nature of the WH notes "enhanced the importance of determining the basic integrity of the issuer's financial statements" and of confirming WH's ability "to pay its bills in the immediate future" (*id.* at 72).

The court of appeals rejected Nuveen's assertion that it could not be held liable under Section 12(2) because the evidence did not show that each investor in the plaintiff class received a misleading prospectus. The court concluded that causation of injury was established because Nuveen sold securities to some purchasers through misleading prospectuses and "publication of WH's true financial condition would have caused a total collapse of the market for its notes" (Pet. App. 9).

DISCUSSION

The decision of the court of appeals does not conflict with any decision of this Court or any other court of appeals. Moreover, the decision appears to turn in substantial part

on the facts of this particular case, and its precedential value in other circumstances is a matter of speculation. Accordingly, review by this Court is unwarranted.

1. Section 12(2) of the Securities Act, 15 U.S.C. 77*l*(2)—a civil liability provision applicable to material misrepresentations and omissions in the sale of registered or unregistered securities—provides an affirmative defense to a defendant who is able to prove that "in the exercise of reasonable care [it] could not have known" of the misrepresentations or omissions. Petitioner Nuveen argues (Pet. 17) that the district court and court of appeals erroneously found that it failed to meet its burden of proof on the issue of reasonable care. There is no need, however, for this Court to review the concurrent factual findings of the lower courts concerning petitioner's negligence.[5]

The inappropriateness of granting review of the facts of this particular case is highlighted by the unusual nature of those facts. The record in this case showed that Nuveen stated to investors that its reports rested on a detailed audit, even though the financial statements that it relied on contained a contrary representation (Pet. App. 6). The need for care arguably was increased in this case by the fact that the notes that Nuveen sold had characteristics unusual for commercial paper. The notes were sold in small denominations, and over half of them were purchased for the account of individuals or by individuals directly, rather than by sophisticated institutional investors (III App. 49; Pet. App.

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[5]Determining whether a defendant has fulfilled a standard of due care requires an assessment of all the facts of record, a task for the lower courts to perform. See, *e.g.*, *Schulz* v. *Pennsylvania R.R.*, 350 U.S. 523, 525 (1956). Congress recognized that liability under Section 12(2) would depend upon the defendant's "importance * * * in the scheme of distribution and * * * the degree of protection that the public has a right to expect." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

29, para. 30).[6] Moreover, the notes were not rated "prime," even though most commercial paper has that rating (*id.* at 30, para. 37).[7]

In light of these unusual factors, the reasoning of the court of appeals in this case will not necessarily apply to other cases involving charges of negligence under Section 12(2). Other courts will undoubtedly recognize that the decision in this case "depends upon the circumstances" presented on the record (Pet. App. 13).

2. Nuveen also argues (Pet. 8-17) that certiorari should be granted to clarify the differences between the standards of care prescribed in Sections 12(2) and 11 of the Securities Act. Section 11 of the Act, 15 U.S.C. 77k, is a civil liability provision that applies only to registered offerings of securities and only to misrepresentations and omissions in a registration statement. In our view, this case is not an appropriate vehicle for clarifying the relationship between Sections 11 and 12(2). Even if, as a general matter, Sections 11 and 12(2) impose distinct standards of care, a standard of care that is the same or similar to that imposed by Section 11 may be appropriate in this unusual factual situation—involving an unregistered offering having many of the characteristics normally associated with an offering required to be registered.[8] In these circumstances, the standard of

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[6]Commercial paper ordinarily is marketed to institutional investors. See generally Board of Governors of the Federal Reserve System, *Statement Regarding Petitions to Initiate Enforcement Action* 1-2 (Sept. 26, 1980); Hurley, *The Commercial Paper Market*, 63 Fed. Res. Bull. 525 (1977).

[7]As of July 30, 1971, only 20 out of 635 commercial paper issuers rated by the National Credit Office were given quality ratings of less than "prime." That rating service later began to list only prime quality commercial paper issuers.

[8]Indeed, the district court concluded that registration was required in this case. See page 4, *supra*.

"reasonable care" under Section 12(2) may converge with the standard of "reasonable investigation" prescribed under Section 11.

In any event, the issue raised by petitioner Nuveen is not properly presented in this case. Nuveen argues (Pet. 9) that the court of appeals held that "the 'reasonable care' defense in Section 12(2) * * * creates the same duties for a seller of securities as the 'reasonable investigation' defense in Section 11 creates for an underwriter * * *." In fact, however, the court of appeals explicitly declined to adopt such a principle (Pet. App. 13):

> Since what constitutes reasonable care under §12(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under §12(2) is always the same as that of an underwriter in a registration offering under §11.

Nuveen also argues (Pet. 13) that the standard imposed by the court of appeals in this case is even more stringent than that imposed under Section 11 because the court purportedly imposed a duty to "investigate the accountants' workpapers * * *." Nuveen suggests that, to satisfy the court of appeals' standard, an underwriter would be " 'under a duty to retain his own auditor to re-examine the books of [the] company * * *' " (Pet. 13-14, quoting *Levine* v. *SEC*, 436 F. 2d 88, 90 (2d Cir. 1971)). In the decision below, however, the court of appeals did not impose such a duty. Instead, it relied on (Pet. App. 5) an earlier decision in this litigation, which stated that examination of accountant's workpapers was but one of three sources of information, "any one of [which] * * * would have revealed deficiencies that would have mandated further inquiry" (Pet. App. 69).

3. Nuveen also argues (Pet. 18-26) that the court of appeals erred in imposing liability in this case because not

all of the investors in the plaintiff class were proven to have received a misleading prospectus distributed by it.

While the court of appeals stated that each plaintiff must prove "some causal connection between the misleading representation or omission and plaintiff's purchase" (Pet. App. 7), it found no requirement that each class member prove that he or she received a misleading prospectus. The court observed (Pet. App. 8; footnote omitted):

> Although the statute explicitly requires privity between plaintiff-purchaser and defendant-seller, its terms do not require that the particular sale to an individual plaintiff be directly by means of the prospectus alleged to be misleading.

Turning to the legislative history, the court noted that Congress recognized that false statements made during the distribution of securities could cause harm to individual investors even though the statements " 'may never actually have been seen by the prospective purchaser * * *' " (Pet. App. 8, quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 10 (1933)). In this case, Nuveen's publication of false reports contributed to the conditions that facilitated sale of the notes—and, conversely, "publication of WH's true financial condition would have caused a total collapse of the market for its notes" (Pet. App. 9).

Nuveen argues that the court misperceived the meaning of the statute and the legislative history and that only those plaintiffs who actually received a misleading prospectus or oral communication can recover under Section 12(2) (Pet. 18-19). While Nuveen's argument is not insubstantial, review of that claim by this Court is not necessary at this time. The narrow legal question whether investors may recover under Section 12(2) based on material misrepresentations and omissions that foster conditions necessary for the sale of securities has not been a recurring one in the

federal courts.[9] Indeed, it appears to be a question of first impression under Section 12(2).[10] Should a conflict among the circuits develop on this issue at a later time, review by this Court may then be appropriate.[11]

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[9]The question whether plaintiffs under Section 12(2) must prove "reliance" on a misleading prospectus or oral communication has been addressed. The courts of appeals that have addressed the question unanimously have held that reliance need not be proved. See *Wigand* v. *Flo-Tek, Inc.*, 609 F. 2d 1028, 1034 (2d Cir. 1979); *Alton Box Board Co.* v. *Goldman, Sachs & Co.*, 560 F. 2d 916, 924 & n.12 (8th Cir. 1977); *Hill York Corp.* v. *American International Franchises, Inc.*, 448 F. 2d 680, 695 (5th Cir. 1971); *Gilbert* v. *Nixon*, 429 F. 2d 348, 356-357 (10th Cir. 1970); *Johns Hopkins Univ.* v. *Hutton*, 422 F. 2d 1124, 1129 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974); *Demarco* v. *Edens*, 390 F. 2d 836, 841 (2d Cir. 1968); *Woodward* v. *Wright*, 266 F. 2d 108, 116 (10th Cir. 1959).

[10]Nuveen urges (Pet. 23-24) that the decision below conflicts with this Court's decision in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 728 (1975), and with the Second Circuit's decision in *Jackson* v. *Oppenheim*, 533 F. 2d 826 (1976). *Blue Chip Stamps*, however, involved no issue under Section 12(2). And *Jackson*, as the court of appeals pointed out (Pet. App. 9 n.7), involved a communication that was not part of an effort to sell securities.

Nuveen also argues (Pet. 24-26) that certiorari should be granted because the decision of the court of appeals may result in liability for persons not in privity with the purchaser. This case is hardly an appropriate vehicle for addressing that question, however, since all of the respondents were in privity with Nuveen.

[11]Other factors suggest that this case is a poor candidate for further review. After a decade of litigation, the 42 class members in this case have received a judgment of approximately $500,000. To reach that result, the parties have gone through a trial and supplemental trial in the district court, have briefed this case in the Seventh Circuit on four separate occasions, and also have obtained review in this Court (see note 3, *supra*). If this Court were to reverse the court of appeals' judgment on the ground that each class member must prove actual receipt of a prospectus, the respondents still would have several alternative grounds for seeking affirmance of the judgment in their favor (see Pet. App. 6 n.3). As previously noted (page 4, *supra*), they obtained a judgment in the district court based on Section 12(1), and the court of appeals did not disturb that ruling. In addition, respondents contend

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JANUARY 1981

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that each class member received misleading *oral* communications, a question on which the court of appeals reserved judgment and which may require further proceedings in the district court. Moreover, several courts have sustained Section 12(2) liability on the basis of implied misrepresentations in cases similar to this, and the court of appeals also reserved judgment on that issue. Thus, a decision by this Court on the issue presented in the petition would not terminate "this protracted litigation" (Pet. App. 59), but rather would only open the door for renewed controversy on these alternative grounds for affirmance.